Managing Global Risks and Creating Prosperity: the Role of the IMF and Regional Financial Architectures

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Abstract

In this paper,following an evolutionary theory of international financial institutions--called “the extended panda’s thumb” approach--- the role of IMF under the present globalization moves is analyzed. It is shown that IMF must change in a direction which allows for greater national policy autonomy. It is also shown that the IMF needs complementary regional institutions of cooperation in order to create a stabilizing financial architecture. Thus regional financial architectures will need to be integral parts of any new global financial architecture(GFA).The tentative steps taken towards regional cooperation in Asia after the financial crisis are discussed to illustrate the opportunities and challenges posed by the need to evolve towards a hybrid GFA.

1.Introduction:

The Asian Financial Crisis and the contagion it created unleashed a process of questioning the wisdom of the standard recipe of the Washington consensus. This is still continuing; but the real costs of crises have forced on the policy agenda the question of what kinds of national and international policies and institutions are appropriate during the current period and in the foreseeable future. In this paper, I will discuss the problems of national macroeconomic policies and governance within a framework of overall global and regional financial architectures. Whether state capacities exist for formulation and implementation of national economic policies may depend in large measure on the kind of global and regional financial architecture in existence.

The methodological approach adopted here is that of evolutionary economics. The institutions I discuss and the alternatives I propose are all path dependent. They all also depend on a supporting structure of complementary institutional network(CIN). Global financial architecture(GFA) and Regional financial architecture(RFA) both depend on their respective CIN within a global system of nation states. Given the real interdependence within the system, all actors have some stake in sustained growth and stability with equity. Thus the central argument of this paper is that sustainable policies at the national level require a supporting network of GFA and RFAs. Such national policies in their turn can contribute to the sustainability of the GFA and RFA. It can be shown that following an evolutionary theory of international financial institutions, two broad types of possible Global Financial Architectures can be identified.[1] In this paper, following Khan(2002c) the first is called an *overarching type*, exemplified by the classical gold standard and the defunct Bretton Woods system. The second is called a *hybrid form* that allows for the existence and coevolution of some Regional Financial Architectures as well. The changing roles of the IMF and national economic policies can be examined within these two possible financial architectures under globalization.

[1] For specific models and arguments see those developed in Khan(2001 and 2002c). Khan(2001) formalizes various types of path dependence. In Khan(2002c) a specific argument called “the extended panda’s thumb” is advanced to urge the utilization of the existing IMF with some modifications in na new, hybrid GFA.

The role of structural unevenness in the global economy is particularly important to recognize within the proposed framework of analysis. The range of economies, the types of polities, the institutional capacities and resource endowments including technological progress and capacities for innovation all vary widely. A simple system of gold standard or adjustable peg or free and flexible exchange rate together with free multilateral trade under, say, the WTO arrangement may therefore be simplistic. It may serve the needs of one group of actors, for example, the advanced economies with well-developed financial services sectors, than some others. How best to achieve a synchronized growth and development regime that is perceived to be fair by all is indeed a challenging problem. The GFA is defined here as a system of global financial arrangements for international payments with specific rules and procedures for the member nations to follow. If there exists a similar institutional arrangement at the supranational but regional level only then I call it an RFA. It will be seen that one attractive solution to the problem of global unevenness is to design a GFA which also includes a number of RFAs as an integral part of the global financial system.

An important initial distinction also needs to be made between crisis management and crisis prevention tasks of GFA and RFAs. Of course, prevention, as the old bromide goes, is better than cure. Therefore, the GFA and RFAs are to be judged optimal in the sense of achieving the highest probability of prevention subject to the constraints of the system. However, it is not clear that the best GFA and RFAs from this perspective are also the best in promoting growth or managing crisis. For example at one extreme, an autarchic system may never have a crisis, but may not promote much growth. If there is a crisis because of domestic moral hazards and adverse selection problems, it may be difficult to manage because capabilities do not exist for crisis management under the assumption that these crises are rare events.But there could be GFAs and RFAs that can potentially develop the capacity for both better crisis management and crisis prevention. In a world of bounded rationality and institutional uncertainty, there may be considerable room for improvement along both the dimensions in an evolutionary sense. However, in such a world the application of the pragmatic principle of prudence would support the development of crisis management capacities at all times, since it will be difficult to prevent crises entirely under any type of open economy GFA and RFAs. The main goals, pragmatically speaking, are to minimize financial and economic instabilities while facilitating global payments, trade and investments.

2. Globalization, Marketization and the Role of Global Capital markets [2]

We owe to the classic work of Karl Polanyi(1944) the realist approach to institutional history. Polanyi shows through his study of the British and West European capitalism under gold standard, how the system broke down because of systemic counterpressures. Together with the classical liberal approach to international money, the attempt to completely commodify labor also met with resistance. Polanyi called such resistance and

[2] This and the next section draw heavily upon Khan(2002c)

the initial policies of marketization , 'a double movement'. This type of double movement is also occurring---at least partially--- under the present regime of globalization which in its extreme forms also tries to extend marketization globally within a neoliberal framework of optimality of the market system approach. However, both parts of such a double movement, in contrast to the powerful labor movements of the past , are still in their infancy. Even so, substantial instability is manifest in the global financial markets. As resistance to further marketization without regulation grows, the instabilities are likely to spread and result also in political and social instabilities as well. For this reason alone, it may be wise to adopt a new and more pragmatic approach to GFA that can help policy making for greater well-being in the nations of the world. As mentioned before, this will help prevent a third type of crisis: a political and social crisis. The developments in Indonesia during the AFC illustrate how suddenly such crises can break out. The evolutionary theory developed here actually suggests a pragmatic path-dependent institution-building approach to a hybrid GFA. But the process is likely to be quite complex.

It is because of such complexities that the term 'globalization' which is so much in vogue today has to be used with caution. When viewed historically, it appears that globalization is a contradictory process of international economic integration that was severely interrupted by the first world war, the great depression, and the second world war. The emergence of the Bretton Woods framework can be seen as a way to integrate the world with respect to trade while controlling the flow of private capital. The demise of Bretton Woods has set in motion forces of capital account liberalization that are often the most visible aspects of 'globalization'. However, even this process is fraught with new instabilities as evidenced by the Mexican and — more recently and even more dramatically — by the Asian financial crisis. At the same time integration of trade even within the standard neoclassical Heckscher-Ohlin-Samuelson model would imply a fall in the wages of unskilled workers of the north thus increasing inequality there (Krugman, 1996; Wood, 1994). The south is supposed to experience a more equalizing effect through trade; but empirically, there is very little evidence of this happening. Therefore, it is necessary to treat the rhetoric of globalization with caution. At best, we are experiencing a `fractured' globalization . Integration of financial markets, for example, can lead to great benefits for all in a truly liberal world of equal actors. However, in a world of unevenness the evolutionary paths may lead to crisis unless institutions are designed properly. Leaving everything to the markets may produce the supreme irony of ultimately leading to crises which prevent some very important capital and commodity markets from functioning.

For these reasons, it is best to ask what roles the global capital markets are supposed to perform in a world of free capital mobility. The functions are variously described, but mainly emphasize the transfer of resources from savers to investors globally. In addition, the agglomeration of capital, selection of projects, monitoring, contract enforcement, risk sharing and pooling of risks are also mentioned. All these are legitimate functions of capital markets. However, despite much talk the crucial problem of handling various kinds of risks and the inability of simple free markets with international capital mobility are nearly always elided.What are some of the most important of these risks?

Exchange rate risk refers to the possibility that a country's currency may experience a precipitous decline in value. This risk is present in any type of exchange rate regime, with full or even partial currency convertibility. Both floating exchange rates and pegging a currency to another single currency, or even a basket of currencies present such exchange rate risk to various degrees.

Capital flight risk refers to the possibility that both domestic and foreign holders of financial assets will sell their holdings whenever there is an expectation of a capital loss. Exchange rate risk is one possible avenue through which such expectations may be formed. As with many types of expectations formation mechanisms, in a world of nonlinearity, bounded rationality and uncertainty, a Keynesian type of short termism takes over. Investors head for the simply on the basis of short term calculations of possible loss, and herd behavior is a likely outcome. Financial distress follows for the hapless country from which capital thus exits in a hurry. In the extreme situation of large short term liabilities, the affected economy may land in a full-blown financial, or even economic crisis.

There is thus a systemic risk of financial fragility associated with the above risks, and the stability of the financial and political ibnstitutions.This type of systemic risk raises the possibility of a financial meltdown.In case of AFC, the risk of financial fragility increased over the 90s through maturity mismatch of loans. The fact that many of the short-term loans were in foreign currencies without risk-sharing mechanisms such as currency swaps in place, created further exchange rate risk which also increased the potential systemic risk. This is consistent with the view of Knight (1998) who affirms that although globalization has brought about spectacular increase in the flow of capital to emerging markets, the Asian financial crisis demonstrates that it can also create financial instability and contagion. Under fairly realistic conditions the banking system of emerging economies can respond in ways that worsen the impact of adverse shocks, causing severe macroeconomic repercussions and exacerbating systemic financial and economic fragility..

In the case of AFC, we also witnessed a fourth kind of risk for vulnerable economies that Knight(1998) and others have also recognized. This is the risk of contagion.[3]Some

[3] Of course, the risk of contagion is always present whenever a financial crisis breaks out. Whether actual contagion is observed depends on a number of factors including the domestic economy's ability to fight off speculative attacks.

countries were unnecessarily victimized simply because expectations moved against their economic prospects as their neighbors experienced financial fragility and capital flight. This has important implications for both global and regional financial architecture. Both GFA and RFAs should try to minimize the contagion risk. Contagion can happen even without much financial and trade openness. However, the more integrated with the rest of the world, or even a region, an economy is, the more is the risk of contagion. There is some theoretical support for this last proposition in specific markets that are being globalized. For example, Calvo and Mendoza (1999) argue that the globalization of securities markets can promote contagion among investors by weakening incentives of gathering costly country-specific information because the marginal benefit of gathering information may be decreasing as securities markets become more global in scope.

The key problem which underlies the above risk scenarios, long recognized by the practitioners before theorists started to study it, is that given informational problems and cost of building enforcing institutions, capital markets are almost always incomplete. Thus classical theorems of welfare economics no longer apply even within a closed economy. In a world of open economies these problems become more severe, and are directly related to the lack of global institutions of governance. The recognition of this point underlies the various proposals advanced so far. As Eichengreen (1999) documents, there are already many proposals for GFAs on the table. Even a partial cataloguing will have to include the many national proposals(e.g., US, UK, French and Canadian proposals), private proposals such as Soros' credit insurance agency,Edward's specialized agencies, Bergsten's target zones etc., and other international proposals. Among the international proposals could be included the IMF proposals,G-7 and G-22 proposals.Although they vary in scope and degrees of political realism, they share one feature in common.All of them fall into the *overarching type* of GFA category.

Although many of the proposals for GFA are possible theoretical solutions the evolutionary approach looks at path dependence and sequential selection processes as crucial. We need to recognize that the actual evolution of such institutions of financial governance will depend crucially on the coordination among the actors, in particular among some key actors in the global system. This leads us to the consideration of an evolutionary structural theory of GFA and RFAs.

3. An Evolutionary Theory of GFA : two evolutionary types of GFA

In order to motivate the discussion we can return to some aspects of AFC. In distinguishing among the countries that managed to survive the AFC and those that did not, John Williamson (1998), one of the proponents of the "Washington consensus," admitted that: "*The one dimension in which there is systematic difference between the two groups is with respect to whether or not they had liberalized their capital accounts.*"

All Asian crisis countries had accepted the IMF's Article VIII obligations, as evident from the historical documents. But as Bhagwati(1998) and others have pointed out, liberalizing trade and liberalizing financial sector have different policy implications. In line with the discussion in the previous section,. theoretically, one should carefully distinguish the welfare impacts of financial market liberalization in an uneven world from such impact in a smooth world of equals with information symmetry.Indded, next to unevenness,. the most critical element is the role and the presence of *asymmetric information*. In a financial market, gathering, selecting, using and providing information are central to its proper functioning, yet it is precisely here that market failures from asymmetric information can arise. (Stiglitz, 1994).

But the evolutionary structural theory goes further than simply cataloguing moral hazard and adverse selection problems. On the *explanans* side are also *the asymmetries in the size, structure and capabilities of the economies and polities*. These asymmetries constrain some polities, particularly the economically disadvantaged ones from developing as quickly as possible in an equitable manner. The recent UNCTAD report on the poorest underdeveloped countries points this out empirically.[4] The theoretical significance of these features of the real world is that no uniform set of rules can work for all the economies and polities in the world. *A fortiori*, it follows that for GFA and RFAs to serve these poor countries as well as the rich countries equally well, special provisions should be in place.

It may appear that the least developed countries are only a special case. But that is not the case. The NIEs, the European social democracies, Japan etc. each in its own way is also different. This poses the real theoretical challenge: how can we even attempt to theorize in the face of such diversity? The way out is through a consideration of the basic

[4] See UNCTAD(2002), particularly sections 5 and 6.

needs of the system and asking if these can be satisfied better under arrangements that are different from the IMF and the "Washington Consensus."

The work by Barry Eichengreen(1999),and others[5] show that it is possible to move beyond the post Bretton Woods situation. In contrast with the conservative Meltzer report, all of these authors emphasize the need to strengthen the IMF in certain dimensions. However, not all of them recognize the crucial need also for the RFAs and the role they can play in creating an enabling environment for the state to implement beneficial economic policies. A completely evolutionary theory of GFA recognizes the need for RFAs from both an *evolutionary* and a *structural* perspective. Given the lack of political resolve, a point made forcefully by Eichengreen among others, there is little chance of creating *institutional structures* in the manner of the 1944 Bretton Woods agreement. The recent path of the world economy does not lead to this immediately. At the same time, the recent path does not lead to only neoliberalism. It is possible to both reform the IMF, as Eichengreen suggests, and to create new RFAs to complement such reforms. Thus this

[5] See for example,Azis, Iwan J (1999) *Do We Know the Real Causes of the Asian Crisis?* Global Financial Turmoil and Reform: A United Nations Perspective, The United Nations University Press, Tokyo.
Khan, Haider A. (forthcoming a) *Global Markets and Financial Crisis: Asia's Mangled Miracle,* Macmillan and St. Martin's Press
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Yoshitomi, Masaru and Kenichi Ohno (1999), "Capital Account Crisis and Credit Contraction: Towards a Better Management of Systemic Curre theory leads to the question of identifying a spectrum of GFAs. Most important among these are those that combine the GFAs like a reformed IMF with appropriate RFAs.

Formally, the heuristic argument presented above can be established via a careful consideration of *path dependence* during evolution of the GFA. In order to do this in a conceptually rigorous manner, the concept of *path dependence* itself has to be refined and formalized in a specific way. I have developed this idea elsewhere, and will only sketch the conceptual path to be followed briefly.[6] As figures 1, 2 and 3 show respectively there can be completely deterministic(CD), completely stochastic(CS), and partially deterministic (PD)characterizations to path dependence. Eschewing the formal apparatus of graph theory and neural network dynamics which can be used to describe these rigorously, we can simply say that in deterministic path dependence there is only one choice of path. Everything is as it should be, since there are no bifurcations at any point in history. In fact, we can make a stronger statement. At *no* point in history is there even a *possibility* of even a bifurcation. Most people will see this as an extreme, and in case of human institutional design, perhaps as an unrealistic case.

<< FIGURES 1,2,3 HERE>>

The purely stochastic case is all *random mutation*.Again, there is no way that conscious choice can play a role here either. Blind chance determines the outcome. The last type of path dependence, i.e., the PD variety leaves some room for evolution to be a result of at least some kind of boundedly rational human activities,as shown in fig. 3. In this case, a complex set of human activities including learning and improving policy making capabilities can influence which network of paths are followed over time. While the number of available paths at any point in history may be large, they are never infinite. Therefore, combinatorial mathematics will in most cases, show the existence of the most likely evolutionary outcome. However, the caveat that large, seemingly random fluctuations(e.g., a war) can throw these calculations off is always a (rare) possibility.

Fortunately, barring such events as wars, revolutions, complete meltdowns of financial systems etc. there are not at present an unmanageably large number of outcomes that are possible for the GFA. In fact, if we are willing to assume a continuum with

[6] See Khan (2001 and 2002c)

nothing but an overarching *global* architecture for international finance with regional impurities added as another type we have just two types of possible evolutionary outcomes for the institutional history of GFAs from a theoretical point of view.

The first type, which can be created at special evolutionary moments can be called *Overarching GFAs.* Gold standard under the UK hegemony and Bretton Woods under the threats of a postwar depression are two examples. Recent history does not support the hope that such events are about to happen again. Therefore, a second type of evolutionary path resulting in a hybrid form should be recognized. This is the hybrid coexistence of a GFA together with one or many RFAs. We can call this type a *hybrid GFA* for shorthand reference. Once again, Asia after the AFC is a good place to begin the analysis.

In the Asian case, as many have observed, the financial sector liberalization followed the pre-AFC GFA by default. There were some short-term gains of the policy , but ultimately it resulted in severe instability. More generally, as Kaminsky & Reinhart (1999) show, based on the episodes of 76 currency crises, of which 26 are also characterized by banking crises, financial sector liberalization can result in a boom-bust cycle by providing easy access to short-term financing. Proponents of liberalization suggest some sort of micro sequencing in order to prevent such adverse consequences.. With some variations,the most commonly suggested sequence is: improve the quality of regulation, make sure they are enforced, and then improve the supervisory mechanisms. Once the markets are liberalized, the level of bank's minimum capital requirements can be brought closer to what the *Basle Accord* requires.

As one author (Azis, 2002c) who, of course, does not use the same terminology as developed here, nevertheless points out, there is a contradiction in this type of GFA arrangement.

> But when the Asian crisis countries liberalized the financial sector in 1980s, the aforementioned preconditions (assumptions) were not in place. Yet, they were rushed to liberalize by the IFI. Ironically, when at the early stage the policy showed favorable impacts, e.g., higher economic growth, greater access to financial services, the IFI applauded it. But when the crisis hit, the very same countries previously praised were swiftly placed into the category of those with misplaced development strategies. All of a sudden, nothing was right with these countries. When confronted with such an embarrassing contradiction, the international institutions are quick to claim that they actually *saw* the faults, and *already reminded* the

governments about the existing flaws (e.g., weak banking system, unsustainable exchange rate system, and widespread corruption).[7]

IMF recommendation during this period led to the increase in interest rates. Because of the common prescription under the GFA this occurred in all Asian crisis countries. Such high rates created more moral hazard and adverse selection problems, thus showing that the incentive system has indeed been altered, and led to the undertaking of bad risk by the banking sector (Hellman, Murdock and Stiglitz, 2000). As Azis(2002c) correctly points out:

> Under these circumstances, the amount of investment credits going to risky sector rose (adverse selection), the incidence of bail out in the absence of free-exit scheme also increased (moral hazard), and the subsequent banks' franchise values (expected returns) declined. All these are precisely what the "pre-conditions prior to liberalization" are expected to avoid. Thus, the implicit logic is inherently self-conflicting, i.e., expecting bank's prudent behavior while allowing 'franchise value' to fall. The suggested preconditions, although seemingly logical, simply do not match with the prevailing institutional conditions.[8]

Azis points out further:

> The IMF persistently argued for liberalizing the sector and meeting the pre-conditions simultaneously. A study by the Fund on the sequencing of capital account liberalization using the case of Chile, Korea, Indonesia and Thailand, for example, stresses the importance of proper sequencing if benefits from the liberalization are to be achieved and the risks to be minimized. The study also argues that financial sector liberalization, especially capital account liberalization, should be a part of a coordinated and comprehensive approach, in which the sequencing of regulatory and institutional reforms is critical. The design of macroeconomic and exchange rate policies should also play a vital role (Johnston, Darbar, and Echeverria, 1997). While intuitively making sense, such conclusions are too broad, far from being practical. No one would argue against the importance of making liberalization policy (or any policy for that matter) consistent with the prevailing macroeconomic policy. But how do you do it, remains unanswered. The information contained in such a study is of limited value to policy makers. Yet, while many countries still had problems to meet the stated preconditions, they were pushed to accelerate the liberalization policy by recommending one or two new measures to safeguard. More often than not, these measures are based on the practice of developed countries that have different institutional conditions.(emphasis mine)[9]

Here the author correctly pinpoints the failure to recognize unevenness as a key feature of the failure of the IMF to prescribe the correct medicine. In fact, IMF did much worse--- it prescribed the wrong medicine, a set of measures that worsened the impact of the AFC. This situation illustrates the danger of being in the grip of a (pseudo-) universalistic theory that simply cannot be applied in the real world of unevenness without serious distortions that may cause great harm. An alternative is to work with our

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[7] Azis(2002c) p.3
[8] Azis(2002c) p.3
[9] Azis(2002c)pp.3-4

type two hybrid combination of GFA and RFAs. Again, Asia can be used as an illustration. There are many aspects one could focus on; I choose to look at the debt and capital flows situation prior to the crisis in specific countries.

Table 1
External Debt Outstanding (Billions of US$)

	1990	1991	1992	1993	1994	1995	1996
ASEAN-4							
External debt	144.3	166.1	180.9	194.1	221.8	257.0	274.5
Short-term debt	25.7	33.8	41.7	49.6	58.2	69.8	80.4
(% of total debt)	17.8	20.3	23.0	25.6	26.2	27.2	29.3
Long-term debt	118.6	132.3	139.2	144.5	163.6	187.2	194.1
(% of total debt)	82.2	79.7	77.0	74.4	73.8	72.8	70.7
Indonesia							
External debt	69.8	79.9	88.3	89.6	96.6	116.3	118.1
(% of GDP)	65.9	68.4	69.0	56.6	54.6	53.3	52.0
Short-term debt	11.1	14.3	18.1	18.0	17.1	24.3	29.3
(% of total debt)	15.9	17.9	20.5	20.1	17.7	20.9	24.8
Long-term debt	58.7	65.6	70.2	71.6	79.5	92.0	88.8
(% of total debt)	84.1	82.1	79.5	79.9	82.3	79.1	75.2
Debt-service ratio	30.9	32.0	31.6	33.8	30.0	33.7	33.0
Malaysia							
External debt	16.0	18.1	19.8	23.2	24.8	33.2	31.6
(% of GDP)	37.6	37.9	34.6	37.1	37.5	40.3	38.1
Short-term debt	1.9	2.1	3.6	6.9	6.2	7.3	7.5
(% of total debt)	11.9	11.6	18.2	29.8	25.0	22.0	23.7
Long-term debt	14.1	16.0	16.2	16.3	18.6	25.9	24.1
(% of total debt)	88.1	88.4	81.8	70.2	75.0	78.0	76.3
Debt-service ratio	10.3	7.7	6.6	7.7	7.7	6.1	6.0
Philippines							
External debt	30.3	32.2	33.3	35.7	39.3	39.5	45.7
(% of GDP)	69.1	71.5	62.3	66.1	61.3	53.2	56.0
Short-term debt	4.4	4.9	5.3	5.0	5.7	6.0	6.3
(% of total debt)	14.5	15.2	15.9	14.0	14.5	15.2	13.8
Long-term debt	25.9	27.3	28.0	30.7	33.6	33.5	39.4
(% of total debt)	85.5	84.8	84.1	86.0	85.5	84.8	86.2
Debt-service ratio	27.0	23.0	24.4	25.5	18.5	15.1	15.4
Thailand							
External debt	28.1	35.9	39.5	45.7	61.1	68.1	79.0
(% of GDP)	32.9	36.4	35.5	41.7	45.3	47.0	49.9
Short-term debt	8.3	12.5	14.7	19.7	29.2	32.2	37.3
(% of total debt)	29.5	34.8	37.2	43.1	47.8	47.3	47.2
Long-term debt	19.8	23.4	24.8	26.0	31.9	35.9	41.7
(% of total debt)	70.5	65.2	62.8	56.9	52.2	52.7	52.8
Debt-service ratio	16.9	13.0	13.7	18.5	15.6	11.7	14.5

Sources: International Financial Statistics, 1997; World Debt Tables, 1996.

Table 2
Net Capital Flows (% of GDP)

	1983-88	1989-95	1991	1992	1993	1994	1995	1996	1997
China									
Net private capital flows	1.2	2.5	1.7	-0.9	4.5	5.6	5.2	4.7	3.7
Net direct investment	0.4	2.9	0.9	1.7	5.3	5.9	4.8	4.6	4.3
Net portfolio investment	0.2	0.2	0.1	-	0.7	0.7	0.1	0.3	0.2
Other net investment	0.5	-0.6	0.7	-2.6	-1.5	-0.9	0.2	-0.3	-0.8
Net official flows	0.3	0.5	0.3	0.8	0.9	0.4	0.3	0.2	-0.1
Change in reserves	-0.4	-2.2	-3.7	0.5	-0.4	-5.6	-3.2	-4.0	-4.5
Indonesia									
Net private capital flows	1.5	4.2	4.6	2.5	3.1	3.9	6.2	6.3	1.6
Net direct investment	0.4	1.3	1.2	1.2	1.2	1.4	2.3	2.8	2.0
Net portfolio investment	0.1	0.4	-	-	1.1	0.6	0.7	0.8	-0.4
Other net investment	1.0	2.6	3.5	1.4	0.7	1.9	3.1	2.7	0.1
Net official flows	2.4	0.8	1.1	1.1	0.9	0.1	-0.2	-0.7	1.0
Change in reserves	-	-1.4	-2.4	-3.0	-1.3	0.4	-0.7	-2.3	1.8
Malaysia									
Net private capital flows	3.1	8.8	11.2	15.1	17.4	1.5	8.8	9.6	4.7
Net direct investment	2.3	6.5	8.3	8.9	7.8	5.7	4.8	5.1	5.3
Net portfolio investment	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Other net investment	0.8	2.3	2.9	6.2	9.7	-4.2	4.1	4.5	-0.6
Net official flows	0.3	-	0.4	-0.1	-0.6	0.2	-0.1	-0.1	-0.1
Change in reserves	-1.8	-4.7	-2.6	-11.3	-17.7	4.3	2.0	-2.5	3.6
Philippines									
Net private capital flows	-2.0	2.7	1.6	2.0	2.6	5.0	4.6	9.8	0.5
Net direct investment	0.7	1.6	1.2	1.3	1.6	2.0	1.8	1.6	1.4
Net portfolio investment	-	0.2	0.3	0.1	-0.1	0.4	0.3	-0.2	-5.3
Other net investment	-2.7	0.9	0.2	0.6	1.1	2.5	2.4	8.5	4.5
Net official flows	2.4	2.0	3.3	1.9	2.3	0.8	1.4	0.2	0.8
Change in reserves	0.5	-1.1	-2.3	-1.5	-1.1	-1.9	-0.9	-4.8	2.1
Thailand									
Net private capital flows	3.1	10.2	10.7	8.7	8.4	8.6	12.7	9.3	-10.9
Net direct investment	0.8	1.5	1.5	1.4	1.1	0.7	0.7	0.9	1.3
Net portfolio investment	0.7	1.3	-	0.5	3.2	0.9	1.9	0.6	0.4
Other net investment	1.5	7.4	9.2	6.8	4.1	7.0	10.0	7.7	-12.6
Net official flows	0.7	-	1.1	0.1	0.2	0.1	0.7	0.7	4.9
Change in reserves	-1.4	-4.1	-4.3	-2.8	-3.2	-3.0	-4.4	-1.2	9.7

Source: World Economic Outlook, December 1997.

As both tables 1 and 2 show the borrowing in short-term market and the increased flow of foreign capital both occurred almost simultaneously in these countries. As the real exchange rate appreciated, competitiveness suffered, and vulnerability to sudden reversals of capital flows increased. It must be emphasized that these were systemic features that went largely unnoticed by the IMF or the private sector. As is well known, in a nonlinear system the vulnerability to sudden shocks is a logical possibility. In case of Asia, this became an empirical reality of nightmare proportions.

. With most debtors being in the corporate sector during the AFC, the capacity to invest became severely constrained. The debt-deflation scenario became the reality because the price effects of depreciated exchange rates did not occur until much later, if at all. Hence, the initial currency crisis became first a more general financial crisis and then a full-blown economic crisis. In Indonesia it also became a social and political crisis

The Asian crisis showed that, the composition of capital flows matters. The fact that there were sudden reversals of capital flows during 1997 and 1998 led many to believe that most capital flows in the region were of portfolio investment type. Reversals of such capital can strain the region’s financial system sufficiently to cause or exacerbate its collapse (Rodrik and Velasco, 1999). However, while it is true that portfolio investment was on the rise, data indicate that foreign direct investment (FDI) remained the largest in all Asian crisis countries. As shown in Table 1, in all Asian crisis countries foreign debts increased persistently until the onset of the crisis. These are debts of the private sector from foreign private lenders.Regional monitoring with the help of a theory such as the one proposed here could have caught the problem and a regionally, ultimately globally, coordinated solution could be attempted. But this was never a possibility under the then existing circumstances. We now know that financial and balance-of-payments crises became interlinked precisely because of the existence of foreign-currency-denominated liabilities (foreign debt) in the domestic financial system (Krueger, 2000). This hindsight can be used to develop RFAs in Asia, Latin America and a few other regions.

In Asia, a "Washington Consensus" policy mix of monetary tightening and fiscal restraints was imposed as part of the IMF conditionalities. The experience during the Mexican crisis in 1995 had convinced the Fund that such a policy mix was appropriate for Asia as well, despite the fact that the pre-crisis conditions in Asia were quite otherwise.[10] Another element emerged in Asia that was indeed new.The IMF suggested a rather radical and fundamental change in the countries' institutional structure. [11].In the event, neither set turned out to have been well-conceived.

As already observed,. the Fund's insistence on severely tightening the monetary policy by raising the interest rates turned out to be incorrect and counterproductive. Its arguments for remaking many institutions in Asia did not make evolutionary sense although all would agree that ending corruption, curtailing special business privileges, and imposing the practice of good governance, including good corporate governance were good overall goals.[12] But quite apart from the wellknown fact that this falls outside the Fund's mandate, such adjustments at the time could result in further instability. In the words of Morris Goldstein, an ex-IMF staff member: "*………both the scope and the depth of the Fund's conditions were excessive…..They clearly strayed outside their area of expertise……If a nation is so plagued with problems that it needs to make 140 changes before it can borrow, then maybe the fund should not lend.*" (New York Times, October 21, 2000). Although not a conscious advocate of the evolutionary theory advanced here, Goldstein's long experience and solid sense of institutional matters led him to the right conclusions in this matter.

[10] James Tobin and Gustav Ranis were among those who believed that the IMF programs in Asia were based on the Fund's experiences with Mexico in 1994: "…..The IMF's Asian packages are based on its experiences with Latin America, in particular with Mexico in 1994." (Tobin and Ranis, 1998).
[11] Azis(2002c) suggests: 'The experience with policy adjustments of this kind in Eastern Europe and the former Soviet Union (from communism to market economy) had inspired the Fund to do the same thing in Asia.' (p.7)
[12] See Khan(1999a, b; and 2001) on Asian corporate governance reform, and the sketch of an evolutionary theory.

4.Towards a Workable Hybrid GFA: RFAs, the IMF and National Policy Management During Transition:

But how is the transition towards a hybrid GFA to be effected? What conceptual modifications are necessary in the way to which we have become accustomed to thinking under the present institutional order? The present and following sections are all intended to answer these questions. The present section will consider some general issues and the possible formation of RFAs while sections five and six will address how the IMF can be modified and what such a modified IMF together with an Asian RFA could have done to handle the situation before, during and after the AFC.

If the argument presented so far is valid, then several propositions can be accepted. First, there may be more than one evolutionary possibility; so there may not be a unique, global optimum set of institutions.Second, the goal of achieving stability and sustainable growth in a world of scarce resources leads to exercising prudence as a principle, particularly when costs are distributed unevenly over space and time. Third, a combination off global institutions with regional and national level institutions may provide more public good than focusing simply at the global level. The case for RFAs has so far rested implicitly on the third proposition. I now wish to elaborate more on this point and link it to the formulation of national economic policies and institution building at the national level as well. It is best to focus again on a concrete case such as the post-crisis Asia to give substance to the formal argument.

Since the crisis, the IMF, the World Bank and the national policy making bodies have been in intense consultation. The individual East Asian economies have taken numerous measures such as improving bank supervision, allowing greater exchange rate flexibility etc. to inoculate themselves against future capital account shocks. However, most of them are still vulnerable to large negative capital account shocks. The national strategy of having a very large stock of foreign reserves to deal with large capital flight may work but it is an extremely expensive strategy. No one can foretell how frequent such crises may be, and how expensive; but if the past is any guide, even infrequent crises can be quite expensive to manage in this manner. This is not to say that such measures should not be taken. On the contrary, these measures are and should be a part of the transitional national management strategy. However, more is clearly needed.It seems that following this logic, an increasing number of East Asian policy makers are realizing that although they may not have the capacity to change the international financial architecture immediately, creating a regional financial architecture may be an attainable goal. There can be a whole range of regional financial cooperation policies leading to more permanent institution building. These could begin with a peer review process such as the G7 process. Using this as the reference point, a move to mutual liquidity provision and some form of enforcement mechanism could be adopted. These could be enhanced through exchange rate coordination and enhanced surveillance process . Ultimately, such a process could evolve into an RFA that could have its own institutional and organizational structure.

In the Asian case, such an evolutionary process has already started . The most important steps taken so far are:the Manila Framework Group Meeting , the ASEAN Surveillance Process , the ASEAN+3 Surveillance Process , and the Chiangmai Inititative-related Surveillance Process.

It can be said that the performance of Manila Framework Group as a mechanism for regional financial cooperation and regional financial surveillance has not yet reached its potential. The reasons are related to institutional incapacity which has prevented the parties from specifying clearly the objectives of information exchange and surveillance. Consequently, no priorities, targets, and rules have been set for the process of information exchange and surveillance.Most importantly,there is no actual peer review process; the surveillance process seems to be simply general discussion of the global and regional economic outlook. Finally, there seems to be no attempt to formulate any country-specific or region-wide recommendations for policy actions--- a point to which I will return at the end.

The other processes also have much room for improvements and the actual prospects for improvement, as shown by the Chiangmai Inititative-related Surveillance Process. In addition to an expanded ASEAN Swap Arrangement (ASA) that includes all ASEAN members and a network of bilateral swap agreements among ASEAN countries plus China, Japan and South Korea, the initiative has opened the door for further discussion about concrete policy coordination and institution building. In so far as the swap arrangements are concerned, currently 10 percent of the swap arrangements can be disbursed without the IMF involvement.

Even with this modest beginning, there is now a need for the swap-providing countries to formulate their own assessments about the swap-requesting country. Costs of such information gathering can be economized through regional cooperation. Such a move will also make it possible to pre-qualify members for assistance if and when the need for such assistance arises. This will also help fight contagion and prevent capital flight when actions are taken promptly before a crisis point is reached because of avoidable delays. Acting in accordance with the principles of prudent management stated earlier, there could be a regular policy dialogue at the deputy minister level. Finally, at the organizational level,the evolutionary approach could lead to the establishment of an independent surveillance unit to serve as the core of an RFA, and to lead the policy dialogue. The proposed policy dialogue process should pay particular attention to the root problems in East Asia's weak financial systems (e.g. prudential supervision, risk management, and corporate governance), and actively promote the development and integration of long-term capital markets. At this point, it is not essential to pinpoint any further the precise organizational blueprint for such an RFA; but the point that the process underway can result in an appropriate institutional structure with proper organizational design is important to grasp. Evolutionary economic theory suggests that an open architecture will be better able to absorb future shocks, learn from them, and modify itself.

There are two key aspects of such an interrelated architecture that will crucially affect the workability of a possible RFA in Asia or in any other region. First, the willingness of a reformed IMF to permit the RFAs to have a certain degree of regional autonomy. For this the complementarity and burden sharing aspects of the GFA with RFAs need to be recognized. This is a special case of complementary institutional network(CIN). Second, and another instance of CIN, is the viability and cooperation at the national level. A slogan accompanying globalization is that the nation state can no longer act on its own. This may be true in certain areas of macroeconomic policy, but on a wide range of issues from tax policies to environmental policies the national governments can within limits formulate and implement policies. In the area of finance, even under WTO rules, there are possibilities of not only policy maneuvering but also of institutional reform and new institution building. In addition to addressing such matters as prudential supervision, risk management, and corporate governance the need for building other institutions for risk sharing, human development and policy dialogues within the nation loom large as tasks during the transitional management at the national level.

One final observation regarding the creation of an RFA within Asia is necessary before moving to a discussion of the future of the IMF in the next section. To put it in the most concrete and perhaps provocative way, could the Chiang Mai initiative foreshadow an East Asian Monetary System?

The AFC has led to a collapse of the dollar pegging most of the economies in East Asia had before the crisis. The East Asian economies prefer a certain amount of exchange rate stability due to their trade multilateral dependence . They also see some advantages to be gained from coordination against speculative attacks, and preventing competitive devaluations in the region. However, fixing rates with respect to one another like the EMS earlier also carries dangers. Furthermore, the US dollar is still the most important vehicle currency in the region.Therefore, whether something like a yen bloc, or even an Asian Currency Unit(ACU) can be created in the near future is doubtful.

At the same time, the experience of the AFC points towards closer coordination and a concerted effort to reduce volatility in the currency and financial markets. Since there are asymmetries among the countries in the region, the more advanced countries need to take the lead and ensure that in times of asymmetric shocks, the less advanced countries will have resources to call upon. Thus any kind of steps towards an RFA will have to involve adequate reserves and the ability to provide liquidity and other resources to countries that need these in times of crisis.

5. The Changing Role of the IMF within a Hybrid GFA:

In this section I want to address what is perhaps the most important institutional and policy question that arises from the proposal for a hybrid GFA. What will be the role of IMF, and how will this new role differ from its present or neoliberal role? As mentioned already, the handling of the AFC by the IMF has raised important issues of global governance. The Fund has been criticized by the left, the right, and also the center.I have already alluded to some of the ways in which the IMF will need to change its ways if the hybrid form of GFA I am suggesting here is to become a viable option for institution building. In Khan (2002c), I have pointed out the need for adhering to so me basic principles as the IMF transforms itself in an "extended panda's thumb" manner. Chief among these principles are the principle of symmetry and the principle of burden sharing.These are described briefly below:

1**.***The principle of symmetry,* i.e., the surplus and deficit countries should be treated equally. Fowever, it was not realized in the past; nor is it likely to be realized in the near future. However, there are various ways to pursue this as a goal even under the current set up of the IMF. If serious efforts are made to follow this principle by a reformed IMF, that will be an important step towards a new and better GFA.
2.*The principle of burden-sharing,* i.e., during episodes of crisis management the IMF will share the management burden with the RFAs and through them also with the affected countries and their neighbors.

It should be kept in mind that in keeping with the "extended panda's thumb" argument both the principles recognize the practical impossibility of the IMF being transformed into a global central bank in the near future. What the IMF cannot do now and will not be able to do in the foreseeable future is to follow Bagehot's dictum to lend freely against good collateral at a high interest rate in time of crisis. Unless SDRs become the commonly accepted and easily expandable means of settlement, this role will remain foreclosed. It is unlikely that the principal shareholders of the IMF will allow such a change to occur.[13] Also, compared to a national central bank dealing with a problematic domestic financial institution the IMF has a limited ability to force corrective action. Yet, there will clearly be a role for IMF lending, and the consequent moral hazard will need to be recognized. But just as the moral hazard from having fire fighters ready to fight fires does not compel thoughtful communities to abolish fire stations, the global community also cannot abolish the IMF, or reduce its resources simply because there is a moral hazard problem associated with such institutions. The second principle above, the principle of burden sharing with the RFAs, national governments and the private sectors should go some distance towards both increasing the overall resources available, and mitigating the moral hazard.

[13] However, this should not be ruled out completely. Pressures for increased supply of SDRs will be beneficial in specific ways as argued below.

While the Fund can not now, or even in the near future be expected to act as a global central banker, pressures for increasing the net supply and poor country allocations of SDR will have beneficial effects. Even if the increases are not significant in the short run, the tendency will keep alive the eventual goal of forming a global central bank, as Keynes had envisioned. More practically, putting pressures on the IMF to emit new SDRs in order to finance the stabilization of primary (and perhaps other) commodity prices will lead to benefits for both the developing and the developed countries in the intermediate run. The stabilization of these prices will help many developing countries avert BOP disasters. Furthermore, to the extent that the unusual price increases, such as the oil price increase in the 70s, create general inflationary pressures such pressures can also be averted. A smooth international transactions pattern will thus be consistent with domestic price stabilization as well.

In addition, the Fund can make a concerted effort to manage the private creditors. Most important from the point of view of managing crises will be the incorporation of new provisions on loan contracts so that orderly work out procedures become feasible. The Fund can also lend into arrears as a means to provide debtor-in-possession financing. Such a provision, along with more direct measures vis-à-vis the creditors, can help to bring the creditors to the bargaining table during a crisis.

Such measures to manage the creditors should also be complemented by increased surveillance of financial markets. Strengthening supervision is one aspect. Arriving at independent assessments of financial risk is another, related aspect of moving in this direction. However, it is important to realize that even after adopting this stance, the risk of crises will still remain. Not all crises can be foreseen, much less prevented. The best that can be done is to draw the countries, the private sector and the RFAs together in an effort to strengthen the financial structures, including information gathering and processing capabilities. A cooperative structure where the Fund recognizes the need for hybridity will also help to reduce the reaction time.

Reducing the reaction time can help only if the policies undertaken can not do much harm even if they are not successful in achieving their positive aim. The IMF has been correctly criticicized for suggesting a "one-size-fits-all" policy package. Here again, a changed institutional structure with a more flexible IMF will mean a case-by-case approach where the RFAs will play a significant role. National economic policies such as requiring borrowers to unwind positions in increasingly risky situations, curbing excessive foreign borrowing, limiting portfolio investment, cautionary policies towards derivatives and off- balance sheet items may need to be examined as serious policy options. Tobin tax, or individual country taxes of the Chilean variety should also be given serious consideration. The *mantra* of free capital movements together with the refrain that there is no alternative needs to be revised appropriately to incorporate the available tools that the Fund can help countries use to mitigate the risks arising from such capital movements.

It is not clear that the Fund can do much in instituting a more stable exchange rate regime. The pegged rate system, advocated among others, surprisingly by the Wall Street Journal, will create one-way bets for speculators. Free floating, on the other hand, can lead to disasters when exchange rates collapse suddenly instead of finding a new stable equilibrium. Such perverse dynamics was observed during the AFC, particularly in the

Indonesian case. Neither currency boards nor perfect flexibility can prevent vulnerable currencies from collapsing. Rather a managed float before any signs of crisis appear together with a prudent management of the financial and real sectors would seem to be both pragmatic and feasible at this point. Strengthening the capacities of central banks will have better pay off here than urging the IMF to twist the arms of the countries through conditionalities.

In Asia, in addition to the high interest rate standard recipe, the IMF seized the crisis as an opportunity to dismantle what remained of the particular mix of institutions that had historically evolved to create the so-called “Asian Model of Development”. Widespread and massive bank closures, enterprise restructuring, opening up sectors to foreign ownership, tearing down labor ibstitutions in the name of flexibility, and attack on living standards seemed to be a part of an overarching agenda. This type of radical restructuring under duress is not the way to apply the principles that are being advocated here.

In spite of widespread criticism from many quarters, the IMF remains committed to capital account liberalization as an ultimate goal. The AFC, and similar crises have merely given it pause to consider proper sequencing before liberalization. The structural evolutionary theory together with the “extended panda’s thumb” argument point to a more nuanced, less global approach. Some econopmies may be ready for capital account liberalization; others are not. The IMF needs to distinguish among them carefully, and not adopt capital account liberalization as a p[rinciple enshrined in its revised articles of agreement.

It goes without saying that proper sequencing, better monitoring and management of debt, greater transparency in both the government and private sector operations, more effective regulation of of domestic financial institutions are all desirable policy goals. Also desirable are domestic tax policies that do not encourage excessive reliance on short-term capital inflows. However, in a world of unevenness some countries may also require temporary capital controls through various means. The IMF, instead of taking a dogmatic approach that says “no” to any form of capital control should set up facilities for examining the impacts of different alternatives. In doing so, it should also pay attention to the principle of symmetry so that the borrowing countries do not always and everywhere have to take the initiative. At the same time both capital inflows and outflows need to be controlled to some extent

A reformed IMF together with the RFAs could take the leadrship in providing the overall framework within which individual countries could pursue policies most advantageous from a systemic point of view .For example, as alluded to already, the hybrid GFA could have a framework agreed to by the member countries of the IMF so that when a crisis hits lenders would be subject to credit standstills and orderly workouts. This would clearly force the creditors to shoulder some of the responsibility for the crisis. Such an arrangement, in all likelihood, will also reduce the need for large IMF loans. Another part of the new IMF responsibilities could be the collection of a global Tobin tax. Although no panacea, such a tax would almost certainly reduce returns to very short-term capital movements. A further consequence of a Tobin tax could be a somewhat more stable exchange rate system. Adoption of a securities transactions tax is also not a far-fetched idea. Even Lawrence Summers wrote academic articles before he joined the government advocating modest taxes on these transactions (Summers and Summers, 1989).

As any international monetary economist knows, the “impossible trinity” of international capital mobility, fixed exchange rate system and an independent monetary policy can not all be pursued together. Slowing down short term capital movement need not prevent long term capital from flowing across borders. However, fixed exchange rates must be given up if countries are still to pursue independent monetary policies. Thus, a return to the old IMF is neither necessary nor desirable. The transformation of the IMF as a handmaiden of the neoliberal agenda in the 1980s shows that something like an “extended panda’s thumb” process was already at work in the post BrettonWoods system IMF. Given sufficient political wisdom and will that process can be reversed towards creating a transformed IMF that can serve the cause of financial stability for global prosperity much better than it has done during the last decades of the twentieth century.This new IMF will adopt a more flexible approach towards national policies. It will recognize that in periods that seem to be leading towards a crisis there may need to be policy shifts such as a shift towards some types of capital controls. The present articles of the IMF actually allow some forms of capital controls when countries are in distress. Instead of dismantling, these provisions have to be made realistic and applicable whenever the financial system seems vulnerable.Thus flexibility and context-dependent policy making will be the key features of a hybrid system. To begin with, debt rescheduling, moderation in fiscal-monetary policy mix with an expansionary bias for most economies and gradual restructuring of corporate sectors with strengthening of standards and corporate governance are steps that IMF can encourage the economies to take without interfering directly with the policy making in specific countries.

Other measures that the IMF can allow or even encourage national governments to pursue could include requiring lending institutions to hold different levels of provisions for countries with different estimated levels of riskiness measured by such factors as the state of the banking system and the level of reserves relative to short-term debt. As many have observed, risk assessment by the credit rating afencies also leaves much to be desired and could be improved if IMF provided some guidance and input. Another, more practical measure would be to impose different levels of taxation on earnings from overseas investments with different maturities. Although as stated in the previous sentence, it will not be so sensitive to individual country risk, it will nevertheless curb some of the tendencies towards short-termism. It should be mentioned that the Basel Committee regulations in effect during the AFC may have been a culprit in this respect. These regulations gave a lower weight to short-term foreign lending (20 per cent) for capital adequacy purposes than for loans with a maturity period of over one year (100 per cent). A new IMF could make such rules less biased by coordinating its guidelines with BIS, and being guided by a better theory than the one underlying the Washington consensus.

6. Summary and Conclusions:

The history of financial crises shows that they can not be prevented once and for all in a monetary economy with unpredictable ebbs and flows in capital movement. This history also shows that financial markets have short memories and limited longterm learning capacity. Thus there needs to be--- within the limits of human fallibility--- a well-designed set of institutions capable of dealing with the tendencies towards financial instability and crisis.

In times of crisis, there are well-meaning suggestions of radical institutional restructuring that fade away when the immediate crisis is over. Only a few farsighted or worrying types may still voice lingering concerns. The AFC, and the proposals for an *overarching type* of GFA--- to use the terminology developed here--- and the subsequent fate of these proposals is a case in point.

Given these features of the real economic world, an evolutionary approach admits of multiple evolutionary equilibria, and a need for realistic institutional design that recognizes path dependence without the disabling and in most cases incorrect slogan that there is no alternative. Such an approach applied to the recent economic history leads to the identification of two broad categories of global financial architectures. The *hybrid* variety advocated here on the basis of both realism and systemic efficacy will nevertheless involve much institution building that is always fraught with the danger of politics-gone- awry.

The dismantling of Chilean capital controls in 1998 is a case in point. In this particular instance, a balance of payments crisis prompted the loosening of capital controls instituted earlier. As Dean(1998) showed the situation of policy and institutional reversal occurred because the interest groups favoring liberalization following a particular world view were strengthened. Such interests in Chile included at that time holders of foreign exchange, exporters, foreign creditors and investors, and the IMF and other international financial institutions. Thus the political problems of coalition building and ensuring the least cost cooperative outcome need attention. The limited achievements and remaining problems that can be seen from the Asian example discussed here should provide concrete motivation to think further about such problems of designing institutions in the real world currently

From the policy perspective, it is important to know if the existence of an Asian RFA would have helped in any way during the AFC. This is really a counterfactual question which asks: suppose there existed an RFA for Asia during the AFC, how would it have responded to the crisis that would have been different?

In contrast with the behavior of the IMF, within the proposed hybrid GFA,a regional financial architecture, had it been present could have done at least the following on the basis of applying an evolutionary theory of financial instabilities under globalization:

1.Through constant regional monitoring it would have sensed the danger ahead of time. Even a regional monitoring unit alone would have been able to do better than the IMF team in Asia.

2.Through constant formal and informal contact with the officials in member governments and the private sector, it would have sized up the possible extent of the problem earlier and better than did the IMF.

3.Through prompt and early action it would have provided liquidity to the system, and punished bad management in coordinated measures with the national governments.

4.It would have been able to start regional discussions about bankruptcy and work out procedures by keeping in close touch with the history and legal issues facing particular countries.

5.It would have been in a position to use both moral suasion and toughness to keep both regional creditors and debtors in line.

The fundamental requirement for this, however, was an actually existing RFA with enough liquidity and technical expertise. The Asian Development Bank provided quite a bit of liquidity to Korea in particular, but did not even have a monitoring unit when the crisis broke out. Furthermore, the autonomy and integrity of any future RFA, in Asia and elsewhere are issues that need discussion. The relationship between the RFAs and the IMF also needs to be further specified. These are matters that are of necessity evolutionary by nature. In this paper, I have tried to specify some principles that may help in selecting the more beneficial evolutionary path.

In Khan(2002c) “the extended panda’s thumb” argument points to the possibility of using our knowledge and ingenuity to utilize existing institutions together with some new ones to achieve desirable goals. In case of GFA, this argument strengthen’s the case for developing the hybrid variety. Using both the existing global institutions such as the IMF, albeit in a modified form, and building upon existing regional initiatives may offer a better chance of creating a beneficial makeshift hybrid GFA than the textbook type pie-in-the-sky schemes correctly dismissed by Eichengreen. However, Eichengreen does not consider the role of RFAs in his otherwise excellent analysis. One way to read the present paper is to see it as filling this gap by using “the extended panda’s thumb” principle along with other arguments. A set of realistic reforms of the IMF together with the formation of RFAs will offer the best chance for the global economy to achieve both stability and prosperity.

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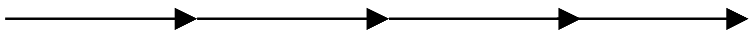
Appendix: Various Types of Path Dependence

Event set at Time Period 0→ leads to→ event set in Period 1→ leads to event

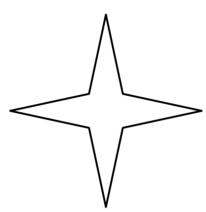
initial period final event



Set in Period 2→ event set n Period n

Figure 1 CD-type path dependence

Event set in period 0 generated stochastically



Event set in period n is also generated stochastically

Figure 2: CS-type path dependence

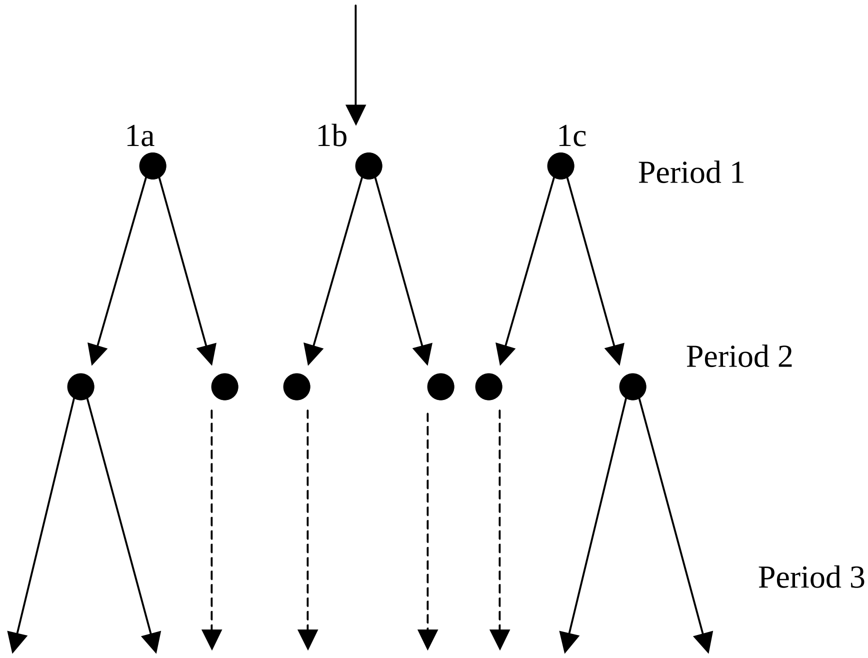


Figure 3: PD-type path dependence